CORE EQUITY REVIEW

Fourth Quarter 2015

ANALYSIS PARALYSIS

PERFORMANCE COMMENTARY

During 2015 and its fourth quarter, there were wide swings in financial markets; stocks, bonds, commodities and currencies. After strong gains from the lows of 2009, the equity market registered a modest gain of 1.4% (S&P 500 TR). However, looking below the surface, there was much turbulence with individual sectors, industries and companies experiencing major declines. While the overall averages signified complacency, in reality there was and continues to be great consternation. We have been, in effect, in a "stealth" bear market.

The concerns plaguing investors have ranged from uncertainty over Federal Reserve policy, to a Chinese economic meltdown, to domestic politics, to rising terrorism here and abroad, and most importantly, to the risk of a recession in the US economy in 2016. To put the magnitude of these concerns in prospective, during the seven year bull market, we have worried over but weathered much greater "crises". Let us not forget the certainty with which we embraced our emotions around the likelihood of the Greek bankruptcy and disintegration of the EU, the dire effects of the US fiscal cliff and sequestration, Ebola's thinning of world populations, and Russia's ominous saber rattling, to cite a few.

Today, the risk with the greatest impact on investor sentiment is the possibility of a US recession and its impact on corporate profits and stock market valuations. The concerns are being fueled by the combination of short term weakness in the manufacturing sector and an over analysis of economic minutia. On any one day, there are a plethora of economic releases which individually are of little importance. But, when accentuated by the financial press and misconstrued by the populace, these cast a pall over investor sentiment. This is the case today. Overwhelmed, we live in a period of "Analysis Paralysis."

In order to bring clarity to today's confusion, better analytical tools are needed. In 1960, Kelly Johnson, an engineer at Lockheed, coined the acronym KISS – keep it simple, stupid. His message was, in seeking answers to problems, unnecessary complexity should be avoided. In analyzing the US economy, the same advice should be heeded. The combination of the vast amounts of economic information available (both government and private), the incentive for bias and the tendency of the press to aggrandize have led to a great deal of "economic" misunderstanding.

The KISS answer to this dilemma is found in Economic 101 textbooks. The basic definition of the output of our economy is **GDP** = **C**onsumption (70%) + **G**overnment (20%) + **I**nvestment (10%) +/- Net **T**rade. For the foreseeable future, the US macroeconomic outlook is: **C**onsumption should be firm with +3% growth given good employment numbers and benefits of reduced oil prices;, **G**overnment should add 0.6% to growth due to new deficits in the Federal budget, the highway bill, and stronger state and local spending**;** **I**nvestment outlook is mixed with normal spending on productivity projects being somewhat offset by continued reductions in the energy patch; **T**rade will continue under pressure as long as the dollar remains strong, which is anticipated, albeit at a somewhat diminished rate.

While current economic reports and forecasts remain cautious, the anticipated ending of the inventory correction will allow for a return to the "new normal", subpar growth of 2-2½%. Doing the math from Econ 101, **C** @ 70% X +3% adds + 2.1% and **G** @ 20% adds +0.6% or +2.7% total in **GDP** growth from these two major factors. It would take major declines in **I**nvestment and **T**rade to cause a recession. This is highly unlikely and we maintain our positive forecast on the US economy for 2016.

The US market averages staged strong rallies in the fourth quarter: S&P 500 +8.1%, Dow Jones Industrials +7.0%, and Nasdaq +8.4%. Respectively, the full year 2015 returns were +2.3%, -2.2%, and +5.7%.

The range of returns within the different market styles was wide for the fourth quarter. Large capitalization growth stocks were strongest at +7.3%, while small capitalization value rose only +2.9%. In all styles (value, blend and growth), large caps dominated. For the full year, the story was the same. Large growth was up +5.7%, with small value down -7.5%. A weakening economy pushed investors toward higher quality, faster growing companies.

In the fourth quarter at the individual sector level, there was a wide dispersion of returns. Clustered at the top were Materials @ +9.7%, Heath Care and Technology @+9.2% each, and Industrials @+8.0%. Lagging were Utilities @+1.1% and Energy @+0.2%. For the full year, there was an aversion to the manufacturing sensitive areas and a preference for growth, both consumer and technological. Consumer Discretionary led with +10.1%, followed by Heath Care @+6.9%, Consumer Staples @+6.6%, and Technology @+5.9%. The losers were hit very hard led by Energy @-21.1% and Materials @-8.4%.

PORTFOLIO COMMENTARY

The largest positive contributor during the fourth quarter was **General Electric (GE)** with a gain of +23.5%. The transition from an over diversified conglomerate to a leading global infrastructure company is being realized and appreciated. During the quarter, **Microsoft (MSFT)** began to articulate its strategy in cloud computing where it holds a number two position to Amazon. The shares responded with a +25.4% gain. **Bristol Myers Squibb (BMY)** was up +16.2% on continued progress in its new oncology drugs and favorable current financial results. **Alphabet (GOOGL)**, up 21.9, continued its strong performance in the quarter in response to greater transparency into its many research and development projects. Revenue and cash flow results were also favorable. **Universal Electronics (UEIC),** a leader in wireless remote control devices, rebounded nicely, +22.2%, along with the market after a poor showing earlier in 2015.

On the negative side, the railroads suffered during the quarter as concerns of a global slowdown, Chinese recession and slowing activity in the US affected investor sentiment. And, in fact, revenues and profits for **Union Pacific (UNP)** -11.6% and **Canadian Pacific (CP)** -11.1% were off meaningfully. In telecommunications, **America Movil (AMX)**, a South American operator, was off -16.7%. Deregulation in Mexico, recession in Brazil, and a weak peso were key negative factors. **Sanofi-Aventis (SNY),** a French pharma company, fell -11.3% in response to an unexpected management change at the CEO level and product disappointments. With poor weather in its markets**, Martin Marietta Materials (MLM),** a leading construction materials company, came under pressure -8.8% in spite of good sales and earnings.

PORTFOLIO ACTIVITY

During the quarter, we realigned our health care position with purchases of **Sanofi-Aventis (SNY)** and **Novo Nordisk (NVO)** and elimination of **Bayer (BAYRY)**. This gives us greater exposure to the pharma area. With growth in telecommunications expected to continue, we increased our holdings in handsets, wireless, and towers with additions to **Apple (AAPL), AT&T (T), America Movil (AMX), American Tower (AMT),** and **Crown Castle (CCI).** Our **Martin Marietta Materials (MLM)** position was increased given our optimism in the federal highway bill. Two companies with challenging intermediate prospects were sold, **Caterpillar (CAT)** and **Cree (CREE).**

MARKET COMMENTARY

While in the case of the US economy, a KISS type GDP analysis is instructive, it is useful to look a bit deeper into other metrics that lead to our optimism. Moving from Economics 101 and using different prisms, we arrive at the same conclusions; that the expansion will continue and profitability will be maintained.

The Economic Cycle – We have held that this economic cycle would be subpar in annual magnitude and resilient in duration. As it enters its eighth year, many feel it will die of old age. The shifting headwinds of impediments to normal growth and the tailwind stimuli of monetary and fiscal policies have held the economy in a growth pattern similar to a square root sign: A big decline in GDP in 2008-9, strong recovery in 2009-10 and until today a slow +1-3% quarterly progression. A square root with a wiggle or squiggle economy.

For this configuration to end with a recession, age will not be the problem. It will require depleting the resources it needs to maintain moderate growth. These include:

- Labor – It must be available and its cost noninflationary. With high underemployment and moderate wages gains, pressures are a few years off.
- Capital – the banking system is awash in reserves and credit markets open for qualified borrowers. The cost of money is low and is expected to remain so in light of the Federal Reserve's moderation in raising rates.
- Plant – capacity utilization is well below levels that would cause bottlenecks or inflationary pricing pressures.

These three factors define the economy's output gap – the difference between what the economy can produce and its current output. As long as this gap is wide and the economy's subpar growth does not close it rapidly, economic expansion can continue for the foreseeable future.

Corporate Profits – Concerns over the sustainability of the record high level of corporate profits bother investors. Historically oriented economists opine that reversion to the mean level of profitability will result in a decline from the current 9% area to the long run average of 6%. This 33% decline would wreck havoc on companies and financial markets. Thus, the heightened anxieties.

Profits are derived from revenues for which we do not have great concerns given our outlook for continued moderate economic growth. And costs, which if elevated, would be problematic. There are five major cost categories affecting profits:

- Labor – there appears little likelihood of major advances in wages over the next few years,
- Raw Materials – with oil and commodities under pressure this is not a cost risk,
- Services – in many areas there are upward pressures in technology and healthcare, but not to the overall economy,
- Interest Rates - while a moderate rise is expected, corporate balance sheets are not at risk either cost or liquidity wise, and
- Taxes – the likelihood of tax reform that would be effective in generating meaningful revenues from business to the government is unlikely. Thus, a meaningful decline in corporate profitability is unlikely.

So, applying a simple KISS style analysis to the revenue and cost components of American corporations, it appears the next few years will not look very different from the past five; moderate growth with sustained profits.

For the US stock market, there could be subtle shifts occurring. As the slow growth economy persists, each year fewer and fewer companies find they have the ability to show strong "organic" revenue and profit growth. Signs of these pressures include more aggressive accounting, strides in creative financial engineering, and heightened merger and acquisition activity.

Over time, investors discount these "band aids" with lower valuations and shift their attention to companies generating internal, organic growth through innovative technologies, new products, and expanded markets. 2015 may have been the watershed year where growth companies/stocks assume a sustained leadership position.

The relative simplicity of our economic analysis frees us from the "Analysis Paralysis" trap which hinders many forecasters today. Given our emphasis on "organic" growth factors in the construction of our investment strategies, our outlook remains positive on the economy, the equity market, and our growth stock philosophy.

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